

REPORT ON EXAMINATION
OF THE
XL SPECIALTY INSURANCE COMPANY
AS OF
DECEMBER 31, 2005

I, Matthew Denn, Insurance Commissioner of the State of Delaware, do hereby certify that the attached REPORT ON EXAMINATION, made as of DECEMBER 31, 2005 of the

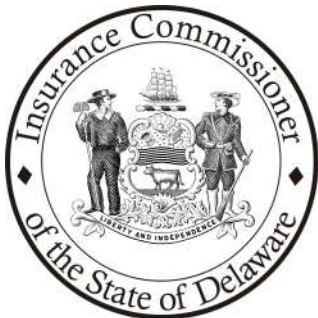
XL SPECIALTY INSURANCE COMPANY

is a true and correct copy of the document filed with this Department.

ATTEST BY:

Antoinette Handy

DATE: 18 OCTOBER 2007



In Witness Whereof, I HAVE HEREUNTO SET MY HAND AND AFFIXED THE OFFICIAL SEAL OF THIS DEPARTMENT AT THE CITY OF DOVER, THIS 18TH DAY OF OCTOBER 2007.

Matthew Denn

Insurance Commissioner

REPORT ON EXAMINATION
OF THE
XL SPECIALTY INSURANCE COMPANY
AS OF
December 31, 2005

The above captioned Report was completed by examiners of the Delaware Insurance Department.

Consideration has duly been given to the comments, conclusions, and recommendations of the examiners regarding the status of the Company as reflected in the Report.

This Report is hereby accepted, adopted, and filed as an official record of this Department.

A handwritten signature in black ink, appearing to read "Matthew Denn", with a stylized flourish at the end.

MATTHEW DENN
INSURANCE COMMISSIONER

DATED this 18TH Day of OCTOBER 2007.

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SALUTATION

August 15, 2007

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3110 State Office Building
Salt Lake City, Utah 84114-1201

Dear Commissioners:

In compliance with instructions and pursuant to statutory provisions contained in Certificate of Authority No. 06-002, dated December 15, 2005, an Association examination has been made of the affairs, financial condition and management of the

XL SPECIALTY INSURANCE COMPANY

hereinafter referred to as “the Company” or “XLSIC” and incorporated under the laws of the State of Delaware as a stock company with its home office located at 1201 North Market Street, Wilmington, Delaware 19801. The examination was conducted at the main administrative office of the Company, located at 70 Seaview Avenue, Stamford, CT 06902.

The report of such examination is submitted herewith.

SCOPE OF EXAMINATION

The last examination was conducted as of December 31, 2002. This examination covers the period since that date through December 31, 2005, and consisted of a general review of the Company's business policies and practices, management, any corporate matters incident thereto, a verification and evaluation of assets and determination of liabilities. Transactions subsequent to the latter date were reviewed where deemed necessary.

The format of this report is designed to explain the procedures employed on examination and the text will explain changes wherever made. If necessary, comments and recommendations have been made in those areas in need of correction or improvement. In such cases, these matters were thoroughly discussed with responsible officials of the Company during the course of the examination.

The general procedures of the examination followed the rules established by the Committee on Financial Condition Examiners Handbook of the National Association of Insurance Commissioners ("NAIC") and generally accepted statutory insurance examination standards consistent with the Insurance Laws and Regulations of the State of Delaware. In accordance with the aforementioned Handbook, the consulting firm of INS Services, Inc. performed an information systems review.

In addition to items hereinafter incorporated as a part of the written report, the following areas were checked and made part of the work papers of this examination:

Statutory Deposits
Employees' Welfare
Legal Actions Pending Settlement
All Asset & Liability Items not mentioned

HISTORY

XLSIC is a Delaware domiciled property and casualty insurer. XLSIC was originally incorporated under the laws of New Mexico as the International Cargo and Surety Insurance Company on November 14, 1979, and began business in the following month. The Company re-domesticated to the State of Illinois in 1989 and changed its name to Intercargo Insurance Company one year later. Effective November 23, 1999, the Company changed its name to its present title. Effective August 16, 2002, the Company re-domiciled from the State of Illinois to the State of Delaware. XLSIC is licensed in all states, except for New Hampshire. XLSIC is also licensed in the District of Columbia, Guam, Puerto Rico and the U. S. Virgin Islands.

XLSIC's immediate parent is Intercargo Corporation ("Intercargo"), a Delaware domiciled corporation. Intercargo is a wholly-owned subsidiary of XL Reinsurance America Inc. ("XLRA"), a New York domiciled insurer, and a wholly-owned indirect subsidiary of X.L. America, Inc. ("X.L. America"), a Delaware domiciled corporation. X.L. America is the ultimate United States parent of XLSIC and its insurer and non-insurer affiliates and is an indirect wholly-owned subsidiary of XL Capital Ltd ("XL Capital"), a Cayman Islands domiciled New York Stock Exchange publicly traded company. X.L. America and its affiliates are members of the XL Capital Holding Company System.

Effective June 30, 2003, with the approval of the Companies' states of domicile, the holding company structure of X.L. America was restructured. As a result of this realignment, XLRA contributed all of the issued and outstanding shares of Indian Harbor Insurance Company ("IHIC"), a North Dakota domiciled insurer, to XLSIC, thereby making IHIC a wholly-owned direct subsidiary of XLSIC.

Effective February 12, 2004, XL Lloyds Insurance Company (“XL Lloyds”) was organized under the Texas Lloyds plan provisions (Chapter 941) of the Texas Insurance Code. XL Lloyds is controlled by XLSIC through trust agreements entered into between the XL Lloyds underwriters and XLSIC. XLSIC contributed all of the funds to the underwriters, which were used by the underwriters to establish the initial guaranty fund and free surplus of XL Lloyds. In return for those funds, the underwriters executed the trust agreements in favor of XLSIC, and the aggregate of the guaranty fund and free surplus constitutes the capital structure of the XL Lloyds. XL Lloyds is also 100% reinsured by XLSIC pursuant to a quota share reinsurance agreement between the two companies.

Executive authority for XL Lloyds is vested in an “attorney” operating under a form of a power of attorney. XL Management Services, LLC (“XLMS”), a Texas limited liability company (and another member of the X.L. America organization), was formed at the same time that XL Lloyds was formed to act as the attorney-in-fact of XL Lloyds. XLMS, through the execution by the XL Lloyds underwriters of powers of attorney, manages the day to day operations of XL Lloyds, including without limitation, executing contracts and filing statutory financial statements on behalf of XL Lloyds.

CAPITALIZATION

Common Capital Stock

The capital stock of the Company has not changed since the previous examination of the Company. The Company has 500,000 authorized shares of \$15.00 par value common capital stock of which 387,500 shares are issued and outstanding to its immediate parent, Intercargo.

Dividends

There were no stockholder dividends paid during the examination period.

MANAGEMENT AND CONTROL

Shareholders

Under the terms of the amended bylaws, meetings of the shareholders shall be held at such time and place, either within or outside the State of Delaware, as shall be designated from time to time by the Board of Directors.

Directors

Pursuant to the general corporation laws of the State of Delaware, as implemented by the Company's Certificate of Incorporation and Bylaws, the business and affairs of the Company shall be managed by or under the direction of the Board of Directors, which shall be determined by the shareholders.

During the period under review, the Board of Directors, as required, held annual meetings as soon as practicable after the annual shareholder's meeting, as well as quarterly meetings. Under the terms of the bylaws of the Company, as adopted by the Board, a majority of the entire Board of Directors shall constitute a quorum for the transaction of business.

There were no amendments to the by-laws of the Company since the previous examination.

Directors duly elected and serving at December 31, 2005 and their residence locations are as follows:

<u>Name</u>	<u>Address</u>	<u>Business Affiliation</u>
Richard Stephen Banas	Lexington, KY	President
Penny Ann Foltz	Dover, DE	Senior Vice President
Richard Harold Miller	New Fairfield, CT	Senior Vice President
Lee Larkin Bennett	Woodstock, MD	Senior Vice President
Dennis Patrick Kane	Island Heights, NJ	Senior Vice President

David Bruce Porteus	Portland, CT	Senior Vice President
David Brian Duclos	Exton, PA	Senior Vice President
Robert Paul Klepper	Asheville, NC	Senior Vice President
Michael Allen Zauderer	Carmel, NY	Vice President
Janet Ericson Duncan	West Hartford, CT	Senior Vice President
Kenneth Peter Meagher	Ridgefield, CT	Secretary

The above mentioned Directors and Officers were traced to the Jurat page of the December 31, 2005 Annual Statement.

Officers

Under the terms of the bylaws of the Company, the officers of the Company shall be a President, a Secretary, and a Treasurer. The Board of Directors, in its discretion, may also choose a Chairman of the Board of Directors (who must be a director) and one or more Vice Presidents, Assistant Secretaries, Assistant Treasurers and other officers. The same person may hold any number of offices, unless prohibited by law or the Certificate of Incorporation. The officers of the Company shall hold office until their successors have been elected and qualified, or until their resignation or removal from office. The senior officers elected during 2005 and serving at December 31, 2005 were as follows:

<u>Name</u>	<u>Title</u>
Richard Stephen Banas	President
Kenneth Peter Meagher	Secretary
Gabriel George Carino III	Treasurer
Lee Larkin Bennett	Senior Vice President
David Brian Duclos	Senior Vice President
Penny Ann Foltz	Senior Vice President
Robert Paul Klepper	Senior Vice President
David Bruce Porteus	Senior Vice President
Richard Thomas Corbett Jr.	Senior Vice President
Janet Ericson Duncan	Senior Vice President
Dennis Patrick Kane	Senior Vice President
Richard Harold Miller	Senior Vice President

During the period under examination, specifically the years 2003 through June 2004, the Company could not produce copies of all notifications of the changes of directors or principal officers to the Delaware Department and as a result, was in violation of -18 Del.C. §4919 - Notice of change of directors or officers.

18 Del.C. §4919 -Notice of change of directors or officers, states:

“Every domestic stock or mutual insurer shall promptly notify the Commissioner in writing of any change of personnel among its directors or principal officers.”

The Company put into effect procedures beginning with August 2004 to ensure that all changes are reported promptly.

It is recommended that the Company report all changes in directors and principal officers to the Delaware Insurance Department as required by 18 Del.C. §4919.)

Conflicts of Interest

The Company maintains a formal written conflict of interest policy statement that has been approved by the Board of Directors.

Signed conflict of interest statements of both Directors and Senior Officers have been traced to the Jurat page of the Annual Statement for all years examined.

Bylaws

A review of the Company's Bylaws revealed that no changes were made during the examination period.

Corporate Records

The Company's corporate records were reviewed for the period under examination.

HOLDING COMPANY SYSTEM

The Company is a member of an Insurance holding company system. X.L. America is the ultimate United States parent of the Company and its insurer and non-insurer affiliates. X.L. America is an indirect wholly-owned subsidiary of XL Capital, a Caymans Islands domiciled New York Stock Exchange publicly traded company. X.L. America and its affiliates are members of the XL Capital Holding Company System. XL Capital, through its principal operating subsidiaries, is a leading provider of insurance and reinsurance coverages and financial products to industrial, commercial and professional service firms, insurance companies and other enterprises on a worldwide basis.

The Form B Holding Company Registration Statements filed with the Delaware Insurance Department during the period under examination were reviewed. Per this review, it was determined that the Company has complied with provisions of 18 Del. Admin. Code 1801 (Formerly Regulation 13.)

An organizational chart which reflects the identities and interrelationships between the Company, its direct and indirect parents, all affiliated insurers and all other members of the holding company system as of December 31, 2005 follows:

TERRITORY AND PLAN OF OPERATION

Territory

As of December 31, 2005, the Company was licensed to write business in all states except for the State of New Hampshire. XLSIC is also licensed in the District of Columbia, Guam, Puerto Rico, and the US Virgin Islands.

Plan of Operation

In 2005, XLSIC's major product lines were professional liability (primarily D&O), aviation, satellite, marine and energy, workers compensation, general liability, surety, and property. These lines are written by the following operating business units ("OBUs"): XL Professional, XL Aerospace, XL Design Professional, XL Programs, XL Marine & Offshore Energy, XL Surety, XL US Primary Risk Management, XL Specie, XL Casualty, XL Equine, and XL Environmental.

For 2005, the Company's premium by OBU was as shown in the table below:

Operating Business Unit	Direct Written Premium (pre-intercompany pooling)
XL Professional	\$630 mm
XL Aerospace	\$390 mm
XL Design Professional	\$157 mm
XL Programs	\$ 69 mm
XL Marine and Offshore Energy	\$112 mm
XL Surety	\$ 59 mm
XL US Primary Risk Management	\$ 79 mm
XL Specie	\$ 33 mm
XL Weather and Energy	\$ 19 mm
XL Equine	\$ 19 mm
XL Other Business Units	\$ 9 mm
Total XLSIC	\$1,576 mm

XL Professional specializes in professional indemnity, directors and officers liability insurance, employment practices liability, and management liability on both a primary and excess basis. XL Professional is based in Hartford, Connecticut. Its clients are Fortune International 1000 companies. XL Professional provides professional liability insurance solutions that minimize risk through tailored products, meticulous service and a focus on long-term partnerships with clients. XL Professional brings industry-leading expertise, service, creativity and financial strength to professional liability insurance. The underwriters work closely with on-staff experts. These experts are familiar with economic, legal and other trends in the industries they serve. This high degree of specialization means that they can tailor programs to customer needs. The philosophy of the XL Professional operations centers on responsiveness, innovative coverage and fair, efficient claims handling. XL Professional has among the highest service standards in the industry, including standards for quote turnaround time, policy issuance, claims resolution and access to staff.

XL Aerospace holds a leadership position as an insurance specialist in the space and aviation classes of business. Its underwriting operations, formerly in Santa Barbara, California, write policies through regional brokers and independent agents. Its clients are corporations in the aviation and space industries, airports, airlines, telecommunications firms and corporate jet fleets. XL Aerospace underwrites US aviation risks and space risks for Africa, Asia, Australia, Europe, North America and South America. Its products include aviation insurance, comprehensive airline hull & liability, airport liability, aviation manufacturers' products liability, aviation ground handlers liability, airport service providers, fixed based operators, contingent aircraft liability, repossessed aircraft hull & liability, large aircraft hull & liability, space third

party liability, corporate non-owned aircraft liability, rotor wing operators, deductible buyback, non-owned aircraft liability, space insurance, launch, post-separation, in-orbit, transponder coverage, satellite incentive coverage, and launch risk guarantee.

XL Design Professional, established in 2004, offers innovative professional liability insurance and risk management solutions to targeted architects and engineers. This OBU's specialized programs protect against and minimize professional liability risks through insurance, proactive loss prevention techniques and expert claims service. The programs are marketed and delivered by a dedicated group of specialists that belong to the Professional Liability Agents Network. These independent agencies have exclusive arrangements to deliver the Company's products and services within their territories.

XL Programs offers specialized insurance coverages to distinct market segments through program administrators. This OBU provides specialty, property & casualty, warranty and intellectual property coverages to various industries, including habitation, real estate, auto and construction. This OBU specializes in crafting customized coverages for programs with distinctive, and often complex, products. It offers the program administrators value-added marketing and regulatory support, including policy form review, compliance, administration and strategic communications. XL Programs is based in Exton, Pennsylvania.

XL Marine and Offshore Energy provides insurance for clients with special coverage needs for their marine or offshore energy exposures. These products are distributed through licensed brokers who offer specific expertise in this area. Product offerings of XL Marine and

Offshore Energy include cargo, blue-water hull, brown-water hull and P&I, primary marine liabilities, excess marine liabilities, and offshore energy insurance. This OBU is headquartered in New York City.

Marine and Offshore Energy lines of business are expected to see flat premiums in 2005. The OBU anticipates rate reductions in the cargo and the offshore energy markets, and flat rates in the marine liability and hull markets. These rate changes will include price and non-price components.

XL Surety, (currently in run-off) wrote contract, commercial and customs surety products. XL Surety provided a full range of surety products and services.

XL US Primary Risk Management was established in 2004 and offers risk transfer and risk management programs for major corporations and institutions operating in the United States. This OBU provides a wide range of solutions to customers with needs for primary programs requiring workers' compensation, general liability and automobile liability. The target customers are small and middle market businesses. The US Primary Risk Management operation is headquartered in New York City.

XL Specie offers specialized solutions for fine art, jewelers block, cash in transit, and financial institutions. Its clients include museums, private and corporate art collections, dealers, auction houses, and jewelry related companies from mining to retail. In the general specie product area, the OBU also offers coverages to banks, financial institutions, miners and refiners,

providing them with coverage for cash, negotiable, non-negotiable documents of value and precious metals.

XL Weather and Energy specializes in weather and energy risk management products which are customized solutions designed to assist corporate customers, primarily energy companies and utilities, to manage their financial exposure to variations in underlying weather conditions and related energy markets. Weather risk management contracts generally average one season (five months) in duration. This OBU uses the capital markets to hedge portions of the risks it has underwritten.

XL Equine specializes exclusively in bloodstock insurance. It provides solutions for equine mortality, barrenness, and prospective foal coverages. XL Equine is recognized as one of the leading providers of equine insurance in the US thoroughbred markets. Products are distributed through a select number of independent agents as well as brokers. The products offered include equine mortality, theft, named perils, stallion permanent disability, stallion first season infertility, stallion availability, stallion loss of income, barrenness (prospective foal), and major medical and surgery coverage.

Best's Rating

Based on AM Best's current opinion of the consolidated financial strength of the members of XL America Group, which operates under a business pooling arrangement, each pool member is assigned a Best Rating of A+ (Superior). The Company is assigned the Financial Category of Class XV, which is the Financial Size Category of the Pool, (\$2 billion).

GROWTH OF THE COMPANY

The following information was extracted from copies of the Company's filed Annual Statements with the Delaware Insurance Department for each year indicated:

<u>Year</u>	<u>Net Admitted Assets</u>	<u>Surplus as Regards to Policyholders</u>	<u>Change in Capital and Surplus</u>	<u>Gross Premiums Written</u>	<u>Net Premiums Earned</u>	<u>Net Income</u>
2005	\$523,786,873	\$142,233,683	1.48%	\$1,658,107,000	\$46,940,599	\$4,147,900
2004	633,571,803	140,159,899	28.03%	1,535,380,000	47,038,449	17,217,757
2003	643,159,379	109,468,139	46.03%	1,279,673,000	37,671,550	(5,992,252)

The Company has experienced mixed results and large variances during the period under examination. The Company incurred growth in premiums and surplus, but declined in admitted assets. Net income has not been consistent. Over the three-year examination period, the following took place:

- A 19% decrease in admitted assets.
- A 30% increase in surplus as regards to policyholders.
- A 30% increase in gross written premium.

The decrease in admitted assets is due largely to a health care receivable being appropriately reclassified to remittances and items not allocated (\$27,124,654). As per the MD&A the remainder is due to the timing of settlement balances.

In 2005, XLSIC has begun to assume 100% of the business of XL Lloyds, an affiliated company offering property protection along the coast of Texas. All business is assumed under a 100% quota share agreement.

XLSIC is a member of the XL Reinsurance America Intercompany Reinsurance Pooling Agreement (the "Pooling Agreement"). Under the terms of the Pooling Agreement, XLSIC and

the other affiliated Pool members cede 100% of their gross premiums, claims, insurance expenses and other related underwriting activity to the Pool leader, XLRA. XLRA cedes 75% of the Pool business, net of specific reinsurance, to its affiliate, XL Re Ltd. The remaining 25% of the business is redistributed among the Pool members ratable to their surplus. XLSIC's current share of the redistribution is 6%.

Historically, the Company's investment income has been consistent, although below the industry average. This is reflective of its conservative investment strategies and philosophies of building long-term value. The group's investment yield has fluctuated over the years in response to some variability in the interest rate environment. The average yield has been supported by the strong growth in invested assets driven by earnings and capital contributions. In previous years, investment income was also aided by the termination of several retrocessional programs and the proceeds subsequently invested. In addition, the group focused on asset/liability matching to mitigate the impact of interest rate fluctuations. In recent years, management has steadily increased its holdings in tax-exempt securities to optimize after-tax investment returns. Net investment income has varied in recent years due to lower interest rates.

Following is a reconciliation of capital and surplus for the period under examination:

Capital and Surplus, December 31, 2002		\$74,961,572
Net income	\$(5,992,252)	
Net unrealized capital gains or (losses)	(660,418)	
Change in net unrealized foreign exchange rate	1,130	
Change in net deferred income tax	2,742,634	
Change in non-admitted assets	(2,670,992)	
Change in provision for reinsurance	7,943,276	
Capital Changes: Paid In	33,168,845	
Aggregate W/I for gains and losses in surplus	(25,656)	
		<u>34,506,567</u>
Capital and Surplus, December 31, 2003		\$109,468,139
Net income	\$17,217,757	
Net unrealized capital gains or (losses)	2,994,782	
Change in net deferred income tax	(1,558,984)	
Change in non-admitted assets	4,633,108	
Change in provision for reinsurance	(5,220,528)	
Capital Changes: Paid In	12,627,342	
Aggregate W/I for gains and losses in surplus	(1,717)	
		<u>30,691,760</u>
Capital and Surplus, December 31, 2004		\$140,159,899
Net income	\$4,147,900	
Net unrealized capital gains or (losses)	1,124,428	
Change in net unrealized foreign exchange rate	502,964	
Change in net deferred income tax	5,611,254	
Change in non-admitted assets	(9,489,687)	
Change in provision for reinsurance	183,720	
Aggregate W/I for gains and losses in surplus	(6,795)	
		<u>2,073,784</u>
Capital and Surplus, December 31, 2005*		<u>\$142,233,683</u>

*(Not including current examination adjustments)

NAIC RATIOS

The Company's NAIC IRIS Ratio tests were available for all years under review. During the examination period, six (6) IRIS ratios produced "unusual values" as defined by the NAIC Examiner Team in 2003, four (4) in 2004 and two (2) in 2005, as shown in the following table:

Year	Ratio *	Ratio Description	Usual Range of Values Over/Under	Company's Result
2003	1	Gross Premiums to PHS	900	999
2003	5	Two Year Operating Ratio	100	104
2003	6	Investment Yield	6.5 3.0	2.8
2003	10	One Year Reserve Development to PHS	20	36
2003	11	Two Year Reserve Development to PHS	20	58
2003	12	Estimated Current Resv. Def. To PHS	25	78
2004	1	Gross Premiums to PHS	900	999
2004	6	Investment Yield	6.5 3.0	2.7
2004	11	Two Year Reserve Development to PHS	20	43
2004	12	Est. Reserve Deficiency to PHS	25	25
2005	1	Gross Premiums to PHS	900	999

Following is a brief description of the underlying circumstances, which produced the “unusual values” in the Company’s IRIS Ratios by examination year:

2003

Ratio 1 – Gross Premiums to Policyholders’ Surplus

For the year ended December 31, 2003, XL Specialty Insurance Company (“XLSIC” or the “Company”) reported gross written premiums of approximately \$1.279.7 billion and policyholder’ surplus of approximately \$109.5 million. The Company is a member of the XL Reinsurance America (“XLRA”) Inter-Company Pool (the “Pool” or the “Pooling Arrangement”, wherein all the Company’s gross written premiums (before the effects of the Pool) are ceded into the Pool. Pool members subsequently assume their pooling participation percentage of underwriting results, which for the Company was 6% in 2003 and 7% in 2002.

Although this ratio is designed to measure the extent to which an insurer relies on reinsurance cessions to reduce its insurance exposure, the ratio does not consider the Company's underwriting strategy which, is to use its Pool participation to provide selection flexibility through the use of rates and forms filed by each of the Pool member companies. Additionally, with total combined (stacked) surplus as of December 31, 2003 of approximately \$1.637 billion, the Company, through its participation in the Pool has adequate capital and surplus to support its current and anticipated net writings. The Company's ratio of net premium writings to capital and surplus in 2003 was only 38.5%, clearly demonstrating that the company is not over-leveraged.

Ratio 5 – Two Year Overall Operating Ratio

The Company's individual net losses and loss adjustment expenses incurred of \$51.6 million in 2003 represented an increase of \$34.4 million as compared to the net losses and loss adjustment expenses of \$17.2 million in 2002. The primary reason for the increase is the Company's share of the Pool's overall incurred losses and loss adjustment expenses attributed to loss reserve strengthening recorded by XLRA.

Ratio 6 – Investment Yield

The Company's unusual ratio result is due the economic realities of the declining interest rate environment throughout the United States during the past year, with yields on long-term bonds declining to less than 5%. Accordingly, the Company believes its current investment yield ratio is reasonable if these factors are considered. The Company does not think it is prudent invest in riskier investment vehicles in order to increase its current yield.

Ratio 10 – One Year Reserve Development to Policyholders' Surplus

The Company's unusual ratio result is primarily due to its share of the Pool's adverse loss development charges recorded in the fourth quarter of 2003 of \$305 million. These charges were recorded primarily for business that was written prior to the merger with XL Capital (July 1, 1999).

Ratio 11 – Two Year Development to Policyholders' Surplus

The Company's unusual ratio result is primarily due to its share of the Pool's adverse loss development charges recorded in the fourth quarter of 2003 and in 2002 of \$305 million and \$115 million, respectively. These charges were recorded primarily for business that was written prior to the merger with XL Capital (July 1, 1999).

Ratio 12 – Estimated Current Reserve deficiency to Policyholders' Surplus

The Company's unusual ratio result is primarily due to the same results discussed in Ratio 11 above.

2004

Ratio 1 – Gross Premiums to Policyholders' Surplus

For the year ended December 31, 2004 and 2003, XL Specialty Insurance Company ("XLSIC" or the "Company") reported gross written premiums of approximately \$1.280 billion and \$1.535 billion, respectively. The Company is a member of the XL Reinsurance America ("XLRA") Inter-Company Pool (the "Pool" or the "Pooling Arrangement", wherein all the Company's gross written premiums (before the effects of the Pool) are ceded into the Pool. Pool

members subsequently assume their pooling participation percentage of underwriting results, which for the Company is currently 6%.

Although this ratio is designed to measure the extent to which an insurer relies on reinsurance cessions to reduce its insurance exposure, the ratio does not consider the Company's underwriting strategy which, is to use its Pool participation to provide selection flexibility through the use of rates and forms filed by each of the Pool member companies. Additionally, with total combined (stacked) surplus as of December 31, 2004 and 2003 of approximately \$1.775 billion and \$1.636 billion, respectively, the Company through its participation in the Pool has adequate capital and surplus to support its current and anticipated net writings. The Company's ratio of net premium writings to capital and surplus in 2004 and 2003 was only 36% and 43%, clearly demonstrating that the company is not over-leveraged. Subsequent to the merger, the Company implemented and continues to improve its underwriting guidelines, such that current business is written at profitable levels.

Ratio 6 – Investment Yield

The Company's unusual ratio result is due the economic realities of the declining interest rate environment throughout the United States during the past year, with yields on long-term bonds declining to less than 5%. Accordingly, the Company believes its current investment yield ratio is reasonable if these factors are considered. The Company does not think it is prudent to invest in riskier investment vehicles in order to increase its current yield.

Ratio 11 – Two Year Reserve Development to Policyholders’ Surplus

The Company’s unusual ratio result is primarily due to its share of the Pool’s adverse loss development charges recorded in the fourth quarter of 2003 of \$305 million. These charges were recorded primarily for business that was written prior to the merger with XL Capital (July 1, 1999). Subsequent to the merger, the Company implemented and continues to improve its underwriting guidelines, such that current business is written at profitable levels.

Ratio 12 – Estimated Current Reserve Deficiency to Policyholders’ Surplus

Similar to Ratio 11 – Two Year Reserve Development to Policyholders’ Surplus, the Company’s unusual ratio result is primarily due its share of the Pool’s adverse net loss development charges recorded in the fourth quarter of 2003 of \$305 million. As noted above, these charges were recorded primarily for business that was written prior to the merger with XL Capital (July 1, 1999). Subsequent to the merger, the Company implemented and continues to improve its underwriting guidelines, such that current business is written at profitable levels.

2005

Ratio 1 – Gross Premiums to Policyholders’ Surplus

For the year ended December 31, 2005 and 2004, XL Specialty Insurance Company (“XLSIC” or the “Company”) reported gross written premiums of approximately \$1.658 billion and \$1.535 billion, respectively. The Company is a member of the XL Reinsurance America (“XLRA”) Inter-Company Pool (the “Pool” or the “Pooling Arrangement”), wherein all the Company’s gross written premiums (before the effects of the Pool) are ceded into the Pool. Pool

members subsequently assume their pooling participation percentage of underwriting results, which for the Company is currently 6%.

Although this ratio is designed to measure the extent to which an insurer relies on reinsurance cessions to reduce its insurance exposure, the ratio does not consider the Company's underwriting strategy which, is to use its Pool participation to provide selection flexibility through the use of rates and forms filed by each of the Pool member companies. Additionally, with total combined (stacked) surplus as of December 31, 2005 and 2004 of approximately \$1.856 billion and \$1.775 billion, respectively, the Company through its participation in the Pool has adequate capital and surplus to support its current and anticipated net writings. The Company's ratio of net premium writings to capital and surplus in 2005 and 2004 was only 33% and 36%, clearly demonstrating that the company is not over-leveraged. Subsequent to the merger, the Company implemented and continues to improve its underwriting guidelines, such that current business is written at profitable levels.

FIDELITY BOND and OTHER INSURANCE

The Company is a covered entity under a Financial Institution Bond in the name of XL Capital, the ultimate parent of the Company. The policy provides a single loss limit of \$70,000,000 with a \$1,000,000 retention. The coverage meets the minimum amount of fidelity bond coverage recommended by the National Association of Insurance Commissioners for the Company and the other named insureds. Other insurance coverage covering the Company appeared adequate.

PENSION PLANS and INSURANCE PLANS

The Company has direct employees. Qualified full-time employees of X.L. America and its subsidiaries, including the Company, are provided with life insurance, accidental death and dismemberment, short and long-term disability, dental and vision benefits, and comprehensive medical expense benefits.

X.L. America (sponsor and plan administrator) offers a 401(k) employee savings plan that allows employees to contribute up to 15% of salary annually. The sponsor will contribute up to 140% matching on up to the first 5% of employee contributions. The sponsor may also make additional discretionary contributions depending on profitability. The matching benefits are vested ratably over 4 years. Forfeitures are used to defray the plan expenses and then plan contributions.

REINSURANCE

During the examination period, January 1, 2003 through December 31, 2005, the Company was a participant in the Pooling agreement. Under the terms of the Pooling Agreement, the Company and the other affiliated Pool members cede 100% of their gross premiums, claims, insurance expenses and other related underwriting activity to the Pool leader, XLRA. XLRA cedes 75% of the Pool business, net of specific reinsurance, to its affiliate, XL Re Ltd. The remaining 25% of the business is redistributed among the Pool members ratable to their surplus. Pool membership and participation during the examination period was as follows:

<u>Company</u>	<u>12/31/2002</u>	<u>12/31/2005</u>
XL Reinsurance America, Inc.	76%	65%
Greenwich Insurance Company	4%	12%
XL Insurance America, Inc.	8%	10%
XL Select Insurance Company	2%	2%
XL Insurance Company of NY, Inc.	2%	3%
XL Specialty Insurance Company	6%	6%
Indian Harbor Insurance Company	<u>2%</u>	<u>2%</u>
TOTAL	100%	100%

The Pool Agreement in place at December 31, 2005 was approved by the Delaware Insurance Department effective December 31, 2002.

The following discrepancy was noted in review of Letters of Credit (“LOCs”):

- Reinsurance recoverables for all Pool members are reported in XLRA's Schedule F, in accordance with the Pooling Agreement. In the case of the AAU voluntary pool, to which XLRA'S affiliate, Greenwich Insurance Company (“GIC”), is a member, ceded reinsurance contracts for AAU accounts name Associated Aviation Underwriters or Associated Aerospace Underwriters as the named reinsured. LOC's securing loss recoverable due from unauthorized reinsurers of the AAU pool similarly name Associated Aviation Underwriters or Associated Aviation Underwriters, Inc. (pool manager) as the beneficiary.

XLRA reported total reinsurance recoverables for authorized and unauthorized AAU reinsurers of \$121,598,106 in its 2005 Annual Statement Schedule F, Part 3. No provision for reinsurance for the AAU account was included in its 2005 Annual Statement since it considered all authorized balances to be current and unauthorized balances to be covered by LOC's. Re-calculation of the aging of paid recoverables determined that 100% of the balance was over 90 days old. This, along with the

determination by the NY DOI that since LOC's did not name XLRA as the beneficiary, but instead named Associated Aviation Underwriters or Associated Aviation Underwriters, Inc. (pool manager), they did not meet the requirements of NY Reg. 133. The failure to name XLRA as the beneficiary on LOC's issued by AAU pool reinsurers was recognized by the company as an error during the 2002 examination, with comments noting its intention to correct the error. This was not done.

Recalculation of the provision for reinsurance for AAU accounts, taking these factors into account, resulted in an addition to the provision. This recalculation included provisions for overdue authorized reinsurance and unsecured unauthorized balances.

A proposed adjustment to surplus for the recalculated amount noted above is recommended for examination purposes, to correct the lack of a provision in the 2005 Annual Statement.

It is recommended that the Company comply with NAIC Annual Statement Instructions for Schedule F, Part 4 and age its paid loss recoverables in accordance with those instructions.

In addition to the ceded and assumed arrangement of the Pooling Agreement, the Company assumed business from non-affiliates. The following indicates the reinsurance assumed from non-affiliates during each year of the examination period:

2005	\$14,667,277
2004	53,250,598
2003	<u>61,440,138</u>
TOTAL	<u>\$129,358,013</u>

INTERCOMPANY AGREEMENTS

The Company had the following intercompany agreements in effect as of December 31, 2005:

Consolidated Income Tax Allocation Agreement

Fifth Amended Tax Sharing and Payment Agreement

The Company along with other members of the X.L. America Group files a consolidated federal income tax return pursuant to the terms of a tax allocation agreement, effective September 1, 2000, and as amended April 1, 2001, July 1, 2001, January 1, 2003 and April 1, 2004. The members of the Group agree to pay an amount equal to the federal income tax liability which such member would have incurred if such member had filed a separate federal income tax return.

For each estimated tax period of any year, the estimated federal income tax liability of each member shall be determined and shall be paid within 10 days of receipt of notice. The final amount required to be paid for any taxable year shall be paid on or before the date on which the consolidated return of the Group is required to be filed determined without regard to any extension of time to file.

The examiner's noted that pro-forma stand alone tax liability for 2005 was settled with X.L. America on December 12, 2006. Section 4.2 of the Fifth Amended Tax Sharing and Payment Agreement ("Agreement") states that "payments shall be made each year on or before the date on which the Consolidated Return of the Affiliated Group is required to be filed without regard to any extension of time that may be required for the filing of any Consolidated Return." This settlement is not in accordance with the settlement terms as specified in the Agreement.

It is recommended that the Company settle tax balances in accordance with the Amended Tax Sharing and Payment Agreement.

Consolidated Services Agreement

Amended and Restated General Services Agreement

The Company entered into a General Services Agreement effective January 1, 2003, with X.L. Global Services, Inc. (“XLGS”), X.L. America and various affiliates that calls for XLGS to provide information and technology services, planning, expense management and budget support, project management and application development support, reinsurance services, actuarial services, human resource services and other services. The services are to be charged on a cost basis. A report covering all the items and incurred charges and/or credits will be furnished quarterly with the final payment being remitted within thirty days upon receipt of the quarterly report.

Second Amended General Services Agreement

Effective January 1, 2003, the Company entered into a General Services Agreement with X.L. America, XLRA, and various affiliates. A summary of the Agreement follows:

- X.L. America shall perform certain management services including but not limited to the payment of expenses for advertising, boards, bureaus and associations, surveys and underwriting expenses, professional fees, total employee compensation, travel and related expenses, rent and rent items, equipment, printing and stationery, postage, telephone and telegraph, legal and auditing, license fees and taxes, actuarial and accounting, administrative and managerial, data processing, claims, regulatory compliance and miscellaneous items. Also, the subsidiaries that pay or perform services which benefit other subsidiaries are allowed to charge the entities benefiting from those payments or

services for the proportionate share of the costs associated with the payment or service provided. Such services are to be provided on a cost basis.

- A report covering all the items and incurred charges and/or credits will be furnished quarterly with the final payment being remitted within thirty days upon receipt of such quarterly report. In no event, shall the cost charged be greater than the Subsidiaries would expend in providing such services for them.

As part of the examiners' expense review, a copy of the reports for 2005 was requested. The Company indicated that no such reports existed, and that the detail of actual charges could not be ascertained because of the way intercompany expenses are pooled. Charges are determined based on allocations of overhead amounts incurred from X.L. America. and XLGS. These amounts are then allocated to XLRA for reinsurance-related expenses and the Company for insurance-related expenses. The insurance-related expenses are then allocated to each legal entity according to the provisions of the Pooling Agreement.

The Company has balances with several of its affiliates which were not settled in accordance with the Service Agreements. The Agreements call for settlement within 30 days after receipt of the quarterly report. The Company's procedural documentation states that settlement of the intercompany balances should occur within 90 days after quarter end. At 12/31/05, the Company did not have a comprehensive procedure in place that required the settlement of all intercompany balances in a timely manner. In November of 2006, the Company issued procedures to cover source balance settlements and regional intercompany settlements. The Company is currently working on identifying old intercompany balances and reconciling

them before the implementation of the new general ledger process in 2008. The Company has initiated a global task force to address the issue as intercompany transactions may also be effected by the foreign currency transactions. It was also noted during the review of the intercompany balances that charges were being made by XL Capital to the Pool companies for stock related compensation. XL Capital is not a party to the Service Agreements.

It is again recommended that the Company implement comprehensive procedures to insure that all intercompany balances are settled in accordance with the service agreements.

It is recommended that the Company develop the ability to age the intercompany items in the new general ledger and that any old inter-company balances be settled prior to the implementation of the new ledger so that initial balances in the new ledger are fully supportable.

EXTERNAL AGREEMENTS

In addition to the above intercompany agreements, the Company had the following external agreement in effect at December 31, 2005:

Investment Custody Agreement

The Company has been party to a Custody Agreement with Mellon Bank since September 30, 2002. Examiners reviewed the SAS 70 Report completed by KPMG LLP on Mellon Global Securities Services as of December 31, 2005. It appears that the custodian has internal controls in place to safeguard the Company's assets and is financially stable. The Company's Custody Agreement is not in compliance with certain provisions as set forth in Part 1, Section IV, J of the NAIC Financial Condition Examiner's Handbook.

- The Custody Agreement dated September 30, 2002 between the Company and Mellon Bank was found to be lacking several provisions as set forth in Part 1, Section IV, J of the NAIC Financial Condition Examiner's Handbook.

It is recommended that the Company amend its Custody Agreement to incorporate the appropriate covenants in accordance with Part 1 Section IV J of the NAIC Financial Condition Examiners Handbook.

LEGAL ACTIONS

The Company is a party to various litigation and claims, common to its business. Management believes that the outcome of such matters will not have a material adverse impact on the financial position or results of operations of the Company. In accordance with NAIC *Annual Statement Instructions*, the Company has made adequate disclosure of its material contingent liabilities where required.

ACCOUNTS AND RECORDS

Accounting System

The Company reports all financial accounting transactions using the PeopleSoft General Ledger application. Statutory financial statements are prepared utilizing the Freedom software application. Enterprise Portfolio System (“EPS”) is utilized for the Company’s investments. The Company additionally utilizes WINS, Genius and Phoenix as its primary commercial insurance processing systems for US business. Functions include policy and claim administration. These systems also serve as source systems for policy production, financial reporting, and statistical reporting. Systems for reinsurance accounting include Destiny and RSG. Standardized insurance accounting procedures are employed in transactions involving premiums, losses, expenses and valuation of assets and liabilities resulting from the operation of the Company.

During the course of the review of the Company’s accounts and records, the operational and organizational controls in place were analyzed. In general, it appears the Company has a sufficient level of controls in place.

However, the following record keeping deficiencies were noted during the course of the current examination:

- The Company was unable to provide detail supporting certain accruals at year end 2005.
 - 1.) Taxes, Licenses and Fees.
 - 2.) Bank fee accruals.
 - 3.) Ceded profit commission (debit balance).

It is recommended that the Company maintain adequate records to support account balances recorded in the general ledger.

- It has been determined by management that the XL Global Risk OBU has been incorrectly posting cash receipts and disbursements to Advance Premiums and instead should have been posting to Remittances and Items not Allocated.

It is recommended that the Company follow NAIC Annual Statement Instructions when completing both its quarterly and annual statements.

- The Company incorrectly posted advanced premiums. XL Global Risk and XL Programs OBUs record premium with effective dates after year end as written premium and offset by unearned premium for the same amount. SSAP #53, Paragraph 13 states: Advanced premiums result when the policies have been processed and the premium paid prior to the effective date.” These advance premiums are reported as a liability in the statutory financial statements and not considered income until due. Such amounts are not included in written premium or the unearned premium reserve.

It is recommended that the Company comply with SSAP #53, Paragraph #13 when recording advanced premiums.

- The Company was incorrectly not carrying any UPR on “run-off” policies. The Company responded that by using underwriting and actuarial pricing assumption, a six year earnings pattern (most policies are issued for a period of six years), it will earn premiums 90% in the first year, 6% in year 2, and 1% in years 3-6. This treatment is consistent with the guidance in SSAP No. 53, paragraph 6, Primary Casualty Contracts. The consulting actuarial firm of INS Consultants agrees with the Company's assertion that 90% of premium will be earned in the first year, 6% in the second year and 1% in years 3-6.

It is recommended that the Company comply with the recommended procedures contained within the NAIC's Accounting Practices and Procedures Manual, SSAP #53, Paragraph 6 when calculating the Company's unearned premium reserve on "run-off" policies.

- As a part of the early close process, it was noted that the Company uses various cut-off dates to recognize written premium from its OBUs. Although the Company uses the cutoff dates to recognize written premium, the Company used the December 31, 2005 date in calculating unearned premium reserve. This accounting underestimates the Company's year-end UPR per annual statement reporting purposes. SSAP 53, paragraph 5 states; “written premiums for all other written contracts, excluding workers' compensation contracts, shall be recorded as of the effective date of the contract. Upon recording written premium, a liability, unearned premium reserve shall be established to reflect the amount of premium for the portion of the insurance coverage that has not expired.”

It is recommended that the Company set up estimated accruals for both written premium and Unearned Premium Reserve that represent written premium and UPR from the cutoff dates to year-end.

- The Company did not accrue for the Profit Sharing Commission payable to Heartland Crop for the Crop Hail and MPCCI business written in 2005.

It is recommended that changes in contract terms be communicated timely to the accounting department so that the appropriate accounting entries can be made.

- As of December 31, 2005, the Company did not have an operational system in place to capture information needed to correctly track and report escheatable property to the various states.

It is recommended that the Company comply with the various state laws regarding escheatable property.

- XLSIC did not accrue for services rendered by KPMG at 12/31/05. KPMG was engaged by the Company in 2005 to conduct an audit of claims processing and procedures. The Company paid \$1,071,747.55 for these services in March 2006. This amount should have been accrued for at 12/31/05. The accrual should not be pooled. The claims processing and procedures audit were for XL Insurance America, Inc., an affiliate, and XLSIC.

It is recommended that the Company develop procedures to ensure that accruals are made for services performed in the current year that remain unpaid at year end.

- The Company needs to clear negative deductible balances including issuing a refund to the claimant if it is found that the Company received deductible payments in excess of the recoverable and non-admit balances greater than 90 days past due.

It is recommended that the Company research and clear the negative deductible balances including issuing a refund to the claimant if it is found that the Company has received deductible payments in excess of the recoverable

It is also recommended that the Company comply with SSAP 65, paragraph 37 and non-admit deductible recoverable balances over 90 days past their contractual due date or billing date if no contractual date has been established.

- The Company failed to book a 90 day overdue balance for the XL Specie OBU at December 31, 2005. The agents' balance for the Vianet Program in the XL Programs OBU should have been non-admitted due to the fact that balances related to the Vianet Program are difficult to age and that there has been historically, a lack of policy level detail received from Vianet.

It is recommended that the Company ensure that they post all non-admitted premium receivable balances in accordance with SSAP 6.

- The examiners requested the Company's worksheets, at the contract level, which compares the accrued retrospective premium receivable balance to the applicable offsets. The Company responded that it did not perform the calculation, but will do so in 2006 and future years.

It is recommended that the Company perform a calculation each year to determine if any accrued retrospective premiums should be non-admitted per the requirements of SSAP 66, paragraph 9.

- It was noted during the examination period that the Company made over-cession of losses from XLRA to XL Re Ltd. of \$90,257,803 in reserves that was associated with the 2003 accident year. The over-cession pertained to a 75% Quota Share Agreement in effect between XL Re Ltd. and XLRA on behalf of itself and its Pool members.

It is recommended that the Company take steps to implement controls to ensure future cessions are allocated correctly and that future financial statements are completed correctly and in compliance with NAIC Annual Statement Instructions.

- Review of XL Group Internal Audit Department reports noted a finding relating to re-allocation of ceded IBNR. This finding described a company practice of re-allocating the portion of ceded IBNR attributable to insolvent reinsurers, to solvent reinsurers, thereby taking credit in Schedule F for IBNR recoverables due from insolvent reinsurers. The recognition of reinsurance recoverable assets or recoverable of liabilities due from insolvent reinsurers is contrary to the requirements of SSAP #62, paragraphs 17-20 and does not meet the test for admitted assets as defined in SSAP #4.

It is recommended that the Company comply with SSAP #62, paragraphs 17-20 by not taking credit in Schedule F for ceded recoverables due from insolvent reinsurers.

- The loss reserves carried by the XL pool members at 12/31/05 showed a subsequent year development deficiency of \$32,325,000 at 12/31/06, per New York Department of Insurance's actuary.

It is recommended that the Company use a more conservative approach when calculating their loss reserves.

IIndependent Accountants

The Company's financial statements are audited each year by the firm of PriceWaterhouseCoopers, LLP ("PwC") of New York, NY. The examiners reviewed the audited statutory financial statements for all years under review and noted that PwC issued an unqualified opinion each year. The workpapers of this firm were made available to the examiners and were used to the extent deemed appropriate for this examination.

Actuarial Opinion

The NY Department of Insurance contracted INS Consultants, Inc. (“INS”) to review the Actuarial Report issued by Tillinghast for the X.L. America Group. INS reviewed Tillinghast’s reconciliations presented in the Actuarial Report by OBU to affirm that the data was appropriately reconciled at the OBU level. Since OBUs do not align with individual Schedule P lines, INS could not perform independent verifications of this data; however, INS accepted each of the reconciliations performed by Tillinghast at this detailed level.

INS reviewed the reconciliation of the total reserving data to the totals from Schedule P, as presented in the Actuarial Report. INS found that the paid loss data and the case reserves matched to corresponding Schedule P data to within 0.5%, both gross and net.

The review stated that the reserves and related actuarial values carried on the balance sheet are fairly stated and met the requirements of the insurance laws of the State of Delaware.

FINANCIAL STATEMENTS

The following pages contain a statement of assets, liabilities, surplus and other funds as of December 31, 2005, as determined by this examination, along with supporting exhibits as detailed below:

Analysis of Assets, December 31, 2005

Statement of Liabilities, Surplus and Other Funds, December 31, 2005

Statement of Income, December 31, 2005

Schedule of Examination Adjustments

It should be noted that the various schedules and exhibits may not add to the totals shown due to rounding. The narratives on the individual accounts, with the exception of the reserve related balances, are presented on an “exception basis” in the Notes to the Financial Statements section of this report.

ANALYSIS OF ASSETS

	<u>Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	
Bonds	\$334,066,939	\$0	\$334,066,939	
Stocks:				
Common	38,458,782	0	38,458,782	
Cash and short-term investments	82,009,728	0	82,009,728	
Interest, dividends and real estate income due and accrued	2,934,226	0	2,934,226	
Agents' balance				
Premiums in course of collection	14,401,849	3,673,040	10,728,809	1
Deferred premiums, agents' balances and installments booked	26,246,730	0	26,246,730	
Accrued retrospective premium	400,274	40,027	360,247	3
Amounts recoverable from reinsurers		(4,933,742)	4,933,742	2
Net deferred tax asset	13,357,444	8,553,440	4,804,004	
Guarantee funds receivable or on deposit	489,263	0	489,263	
EDP Equipment and software	10,745	0	10,745	
Receivable from parent, subsidiaries and affiliates	21,744,693	0	21,744,693	
Receivable from Federal Crop Insurance Corporation	1,293,512	0	1,293,512	
Deductible recoverable	344,975	173,898	171,077	4
Employee Cash Advances	11,278	11,278	0	
Prepayments	3,361,381	3,361,381	0	
Security Deposits	27,544	27,544	0	
Receivable from Sellers	2,000,000	2,000,000	0	
	<u> </u>	<u> </u>	<u> </u>	
Total Assets	<u><u>\$541,159,363</u></u>	<u><u>\$12,906,866</u></u>	<u><u>\$528,252,497</u></u>	

Liabilities, Surplus And Other Funds**As of December 31, 2005**

		<u>Note</u>
Losses	\$136,730,794	2,10,11
Reinsurance payable on paid losses	2,296,396	
Loss adjustment expenses	9,754,513	
Contingent commissions	1,508,448	5,6
Other expenses	4,568,598	
Taxes, licenses and fees	1,652,515	
Current federal income taxes	6,333,492	
Unearned premiums	24,819,727	7
Advance premiums	6,146,974	
Funds held by company under reinsurance treaties	150,972,395	
Amounts withheld or retained by company for account of others	1,230,366	
Remittances and items not allocated	(9,847,537)	
Provision for reinsurance	10,780,078	8
Payable to parent, subsidiaries, and affiliates	26,747,727	
Payable for securities	16,330,081	
Unearned Fee Income	26,787	
Contingency Reserve for Adverse Losses	36,246	
Accounts Payable	1,362,539	9
Deposit Liability	352,399	
Premium Deficiency	245,958	
Insurance payable on Paid Loss and loss adjustment expenses	310,041	
Deferred Commission Revenue	6,991,352	
Total Liabilities	\$399,349,889	
Common capital stock	\$5,812,500	
Gross paid-in and contributed surplus	131,798,019	
Unassigned funds (surplus)	(8,707,910)	
Surplus as regards policyholders	128,902,609	
Total liabilities and surplus	\$528,252,498	

Statement of Income
As of December 31, 2005

UNDERWRITING INCOME

Premiums earned	\$46,940,599
DEDUCTIONS:	
Losses incurred	\$35,488,215
Loss expenses incurred	5,986,695
Other underwriting expenses incurred	7,732,865
Aggregate write-ins for underwriting deductions	245,958
Total underwriting deductions	\$49,453,733
Net underwriting gain or (loss)	(\$2,513,134)

INVESTMENT INCOME

Net investment income earned	\$16,338,104
Net realized capital gains or (losses)	(254,211)
Net investment gain or (loss)	\$16,083,893

OTHER INCOME

Net gain or (loss) from agents' or premium balances charged off	\$106,827
Aggregate write-ins for miscellaneous income	(4,203,697)
Total other income	(\$4,096,870)

Net income before dividends to policyholders and before federal income taxes	\$9,473,889
Dividends to policyholders	\$0
Net income after dividends to policyholder but before federal income taxes	9,473,889
Federal and foreign income taxes incurred	5,325,989

NET INCOME	\$4,147,900
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CAPITAL AND SURPLUS ACCOUNT

Surplus as regards policyholders, December 31, 2004	\$140,159,899
GAINS AND (LOSSES) IN SURPLUS	
Net income	\$4,147,900
Net unrealized capital gains or (losses)	1,124,428
Change in net unrealized foreign exchange capital loss	502,964
Change in net deferred income tax	5,611,254
Change in non-admitted assets	(9,489,687)
Change in provision for reinsurance	183,720
Aggregate write-ins for gains and losses in surplus	(6,795)
Change in surplus as regards policyholders for the year	\$2,073,784
Adjustment to surplus as a result of 12/31/05 Examination	(\$13,331,074)
Surplus as regards policyholders, December 31, 2005	\$128,902,609

Schedule of Examination Adjustments
As of December 31, 2005

<u>Description</u>	<u>Per Examination</u>	<u>Per Company</u>	<u>Surplus Increase (Decrease)</u>	<u>Note</u>
Assets:				
Agents' balances	\$10,728,809	\$11,002,429	(\$273,620)	1
Reinsurance recoverables on loss and LAE	4,933,742	0	4,933,742	2
Accrued retrospective premiums	360,247	400,274	(40,027)	3
Aggreg. W/I for other than invested assets	171,077	325,548	(154,471)	4
Adjusted Admitted Assets	<u>\$16,193,875</u>	<u>\$11,728,251</u>	<u>\$4,465,624</u>	
Liabilities and Surplus:				
Loss and LAE	(\$146,485,307)	(\$132,877,354)	(\$13,607,953)	2,10,11
Commissions payable	(1,508,448)	(1,286,042)	(222,406)	5,6
Unearned Premium	(24,819,727)	(24,663,062)	(156,665)	7
Provision for reinsurance	(10,780,078)	(7,034,708)	(3,745,370)	8
Accounts payable	(1,362,539)	(1,298,234)	(64,305)	9
Unassigned Funds (Surplus)	8,707,910	(4,623,164)	13,331,074	
Adjusted Liabilities and Surplus	<u>(\$176,248,189)</u>	<u>(\$171,782,564)</u>	<u>(\$4,465,625)</u>	

NOTES TO FINANCIAL STATEMENTS**Assets**

(1) **Agents Balances:** **\$10,728,809**

The above captioned amount reflects adjustments decreasing the balance reported by the Company by \$273,620 for over 90 day balances for the Company OBU and the Vianet Program premiums. The adjustment to the Company as a member of the Pool is 6% of \$4,560,336 or \$273,620.

(2) **Reinsurance Recoverable:** **\$4,933,742**

The above captioned amount reflects an adjustment increasing this account by \$4,933,742. During the course of the examination, the Company notified the examiners of the over-cession of losses from XLRA to XL Re Ltd. of \$90,257,803 in reserves that was associated with the 2003 accident year. The over-cession pertained to a 75% Quota Share Agreement in effect between XL Re Ltd. and XLRA on behalf of itself and its Pool members. Because of the over-cession, the Pool needed to make the following adjustments to correct its financial statements in the 3rd qtr, 2006:

	<u>Debit</u>	<u>Credit</u>
Reinsurance Recoverables	\$82,229,016	
Case Reserves	\$39,108,674	
Surplus	\$90,257,803	
IBNR Reserves		\$211,595,493

The allocation to XLSIC as a member of the Pool is as follows:

<u>Losses</u>	<u>Reinsurance Recoverable</u>
6% of \$172,486,819 = \$10,349,210	6% of \$82,229,016 = \$4,933,742

(3) Accrued Retrospective Premiums: \$360,247

The above captioned amount reflects an adjustment decreasing the Company's reported balance by \$40,027. The examiners requested the Company's worksheets, at the contract level, which compares the accrued retrospective premium receivable balance to the applicable offsets. The Company responded that it did not perform the calculation. The examiners had no documentation to determine if there were any excess over offsets. The examiners assumed that there were no offsets and non-admitted 10% of the reported balance (\$6,671,231 X 10%) to comply with the requirements of SSAP 66, paragraph 9. The adjustment to XLSIC as a member of the Pool is 6% of \$667,123 or \$40,027.

(4) Deductible Recoverable \$ 171,077

The above captioned amount reflects an adjustment decreasing this asset by \$154,471. The examiner noted that the Company had balances in Genius of \$2,496,493 and in GAIN of \$195,463.79 which were over 90 days past due. These amounts should be non-admitted for examination purposes in accordance with SSAP 65, paragraph 37 which states that "Deductible recoverables that are greater than ninety days old shall be non-admitted." After application of cash received that was not processed against these balances of \$117,447, the non-admitted portion is \$2,574,510 for the Pool. The adjustment to XLSIC as a member of the Pool is \$154,471 (\$2,574,510 X 6%).

Liabilities

(2) Losses: (\$133,472,051)

Loss Adjustment Expenses: (\$9,754,513)

The above captioned amount on a combined basis is \$10,349,210 more than that reported by the Company in its 2005 Annual Statement. During the course of the examination, the Company notified the examiners of the over-cession of losses from XLRA to XL Re Ltd. As a result, the Delaware Insurance Department retained the services of a consulting actuary to conduct an independent review of the Company's loss and loss adjustment expense reserves as of December 31, 2005. Note that the above adjustment to "Losses" is a result of XLRA overceding a total of \$90,257,803 in reserves that was associated with the 2003 accident year. The over-cession pertained to a 75% Quota Share Agreement in effect between XL Re Ltd. and XLRA on behalf of itself and its Pool members. Because of the over-cession, the Pool needed to make the following adjustments to correct its financial statements in the 3rd qtr, 2006:

	<u>Debit</u>	<u>Credit</u>
Reinsurance Recoverables	\$82,229,016	
Case Reserves	\$39,108,674	
Surplus	\$90,257,803	
IBNR Reserves		\$211,595,493

The allocation to XLSIC as a member of the Pool is as follows:

<u>Losses</u>	<u>Reinsurance Recoverable</u>
6% of \$172,486,819 = \$10,349,210	6% of \$82,229,016 = \$4,933,741

(5, 6) Commissions Payable

\$1,508,448

The above captioned amount reflects two adjustments to increase this liability account by \$222,406. The first adjustment resulted from the Pool failing to accrue for the Profit Sharing Commission payable to Heartland Crop for the Crop Hail and MPCCI business written in 2005. Heartland Crop had a 45% profit sharing commission on the business. The estimated liability for the profit sharing commission due on 2005 business was \$11,180,443. This amount was subject to an 85% crop hail quota share retrocession and to the 75% Quota Share Agreement with XL Re, Ltd. The amount of the adjustment to the Pool was \$419,267. The adjusting entry for the entire Pool was:

	<u>Debit</u>	<u>Credit</u>
Surplus	\$ 419,267	
Commissions Payable		\$ 419,267

The allocation to XLSIC as a member of the Pool was 6% of the above or \$25,156). The second adjustment resulted from XLRA's failure to provide valid support for general ledger account #208723 - Ceded profit commission (debit balance) in the amount of \$3,287,498 as of December 31, 2005. The post-pooling adjustment to XLSIC was 6% of the total or \$197,250.

(7) Unearned Premium

\$24,819,727

The above captioned amount reflects an adjustment increasing this liability for \$156,665. Examiners noted during the sample testing of various lines of business that the Company incorrectly calculated UPR for the XL Professional OBU on "Run-Off" policies. Run-off policies occur when an event changes the original make-up of the Company (i.e.

acquisition, change of Board members or merger) which causes the original Board of Directors to be left without D&O coverage. The original D&O policy goes into run-off upon the trigger event and the unearned premium is returned to the client. A run-off premium is charged to provide an extended reporting period normally for 3 to 6 years for coverage to the Directors for the original policy period up to the date of the event. This is done because the exposure period is in the past, and the policy premium received for the run-off policy is not subject to the return premium process. The run-off endorsement states that the premium is fully earned on the date of the event and will not be returned to the client if the endorsement is cancelled. The Company was incorrectly not carrying any UPR on this type of policy.

The Company responded that by using underwriting and actuarial pricing assumption, a six year earnings pattern (most policies are issued for a period of six years), it will earn premiums 90% in the first year, 6% in year 2, and 1% in years 3-6. This treatment is consistent with the guidance in SSAP No. 53, paragraph 6, Primary Casualty Contracts. Bob Gardner, an actuary employed by INS Consultants, agrees with the Company's assertion that 90% of premium will be earned in the first year, 6% in the second year and 1% in years 3-6. The Company provided a spreadsheet which calculates the UPR based on the earnings curve. This workpaper shows that the Company has a \$10,444,331 difference in what the Company has for UPR on this type policy and what the recalculated UPR should be based on the earnings curve at December 31, 2005. The \$10,444,331 is subject to the 75% Quota Share Agreement. Therefore, the adjustment is

$\$10,444,331 - \$7,833,248 = \$2,611,083$ to the Pool. The Company's portion of this adjustment to surplus is 6% or \$156,665.

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(8) Provision for Reinsurance

\$10,780,078

The above captioned amount reflects an adjustment of \$3,745,370 increasing this liability. This adjustment was a result of reinsurance recoverables for all Pool members as reported in XLRA's Schedule F, in accordance with the Pooling Agreement. In the case of the AAU voluntary pool, to which XLRA'S affiliate, Greenwich Insurance Company, is a member, ceded reinsurance contracts for AAU accounts name Associated Aviation Underwriters or Associated Aerospace Underwriters as the named reinsured. LOC's securing loss recoverable due from unauthorized reinsurers of the AAU pool similarly name Associated Aviation Underwriters or Associated Aviation Underwriters, Inc. (pool manager) as the beneficiary.

XLRA reported total reinsurance recoverables for authorized and unauthorized AAU reinsurers of \$121,598,106 in its 2005 Annual Statement Schedule F, Part 3. No provision for reinsurance for the AAU account was included in its 2005 Annual Statement since it considered all authorized balances to be current and unauthorized balances to be covered by LOC's. Re-calculation of the aging of paid recoverables determined that 100% of the balance was over 90 days old. This, along with the determination by the NY DOI that since LOC's did not name XLRA as the beneficiary, but instead named Associated Aviation Underwriters or Associated Aviation Underwriters, Inc. (pool manager), they did not meet the requirements of NY Reg. 133.

The failure to name XLRA as the beneficiary on LOC's issued by AAU pool reinsurers was recognized by the company as an error during the 2002 examination, with comments noting its intention to correct the error. This was not done.

Recalculation of the provision for reinsurance for AAU accounts, taking these factors into account, resulted in an addition to the provision of \$62,422,826 for the Pool. This recalculation included provisions for overdue authorized reinsurance and unsecured unauthorized balances.

A proposed adjustment to surplus for the recalculated amount noted above is recommended for examination purposes, to correct the lack of a provision in the 2005 Annual Statement. XLSIC's portion of this adjustment to surplus is 6% of the total or \$3,745,370.

(9) Accounts Payable

\$1,362,539

The above captioned amount reflects an adjustment of \$64,305 increasing this liability. XLSIC did not accrue for services rendered by KPMG at 12/31/05. KPMG was engaged by the Company in 2005 to conduct an audit of claims processing and procedures. The Company paid \$1,071,747.55 for these services in March 2006. This amount should have been accrued for at 12/31/05. The post pooling adjustment to XLSIC was 6% of the total or \$64,305.

(10) Losses and LAE \$146,485,307.

The above captioned amount reflects an adjustment of \$1,312,743 increasing this liability. Review of XL Group Internal Audit Department reports noted a finding relating to re-allocation of ceded IBNR. This finding described a company practice of re-allocating the portion of ceded IBNR attributable to insolvent reinsurers, to solvent reinsurers, thereby taking credit in Schedule F for IBNR recoverables due from insolvent reinsurers. XL Group re-allocated IBNR totaling \$21,879,055 for the Pool in XLRA's 2005 Annual Statement Schedule F. The recognition of reinsurance recoverable assets or recoverable of liabilities due from insolvent reinsurers is contrary to the requirements of SSAP #62, paragraphs 17-20 and does not meet the test for admitted assets as defined in SSAP #4. The post pooling adjustment to XLSIC was 6% of the total or \$1,312,743.

(11) Losses and LAE \$146,485,307

The loss reserves carried by the XL pool members at 12/31/05 show a subsequent year development deficiency of \$32,325,000 at 12/31/06 per New York Department of Insurance's actuary. Based on the actuary's development for each Pool Member the adjustment for XL Specialty was \$ 1,946,000.

COMPLIANCE WITH PRIOR REPORT RECOMMENDATIONS

A review was performed of appropriate balance sheet and forepart files to verify corrective action had been taken with regards to prior examination report comments and recommendations.

Management and Control

Board of Directors

1. Prior Exam Comment: It is recommended that the Company report all changes in directors and principal officers to the Delaware Insurance Department as required by 18 Del.C. §4919.

Current Exam Finding: A review of all changes to officers and directors of the Company during the examination period revealed that not all changes had been reported to the Delaware Insurance Department in accordance with 18 Del.C. §4919. Accordingly, the prior report recommendation remains open as of December 31, 2005. It is noted that the Company put into effect procedures to comply with the reporting requirements in 2004. (See current examination recommendation noted in the “Management and Control” section of this Report, under the caption “Officers”)

Territory and Plan of Operation

Managing General Agents

2. Prior Exam Comment: The 2002 examination report contained 14 recommendations relating to the Managing General Agents Act and Agreements. All recommendations were cleared except as follow:

- **It is recommended that the Company comply with 18 Del. C. § 1805 (a) by obtaining copies of the MGA CPA audit reports. Two out of the three reports reviewed were audited. The third was only a complied financials. REPEAT FINDING.**
- **It is recommended that the Company comply with 18 Del. C. § 1805(b) by obtaining the opinion of an actuary attesting to the adequacy of the MGAs established loss reserves. The Company does not obtain actuarial opinions. REPEAT FINDING.**

SUMMARY OF RECOMMENDATIONS

Management and Control (Page #7)

It is recommended that the Company report all changes in directors and principal officers to the Delaware Insurance Department as required by 18 Del.C. §4919.

LOC effect on Provision for Reinsurance (Page #26)

It is recommended that the Company comply with NAIC Annual Statement Instructions for Schedule F, Part 4 and age its paid loss recoverables in accordance with those instructions.

FIT Intercompany Settlement (Page #27)

It is recommended that the Company settle their Federal Income Tax related intercompany balances in accordance with the Company's Amended Tax Sharing and Payment Agreement.

Intercompany Balances (Page #30) It is again recommended that the Company implement comprehensive procedures to ensure that all intercompany balances are settled in accordance with the service agreements.

Aging Intercompany Balances (Page #30)

It is recommended that the Company develop the ability to age the intercompany items in the new general ledger and that any old intercompany balances be settled prior to the implementation of the new ledger so that initial balances in the new ledger are fully supportable.

External Custody Agreement (Page #31)

It is recommended that the Company amend its custody agreement to incorporate the appropriate covenants in accordance with Part 1 Section IV J of the NAIC Financial Condition Examiners Handbook.

Taxes, Licenses and Fees (Page #32)

It is recommended that the Company maintain supporting documentation for account balances. The Company is in violation of 18 Del. C. § 520(b), (3), which states in part..."or to produce its accounts, records and files for examination by the Commissioner when required"

Reclassification of Advance Premiums (Page #32)

It is recommended that the Company follow NAIC Annual Statement Instructions when completing both its quarterly and annual statements.

Advance Premium (Page #32)

It is recommended that the Company comply with SSAP #53, Paragraph #13 when recording advance premiums.

Unearned Premium Reserve (Page #33)

It is recommended that the Company comply with the recommended procedures contained within the NAIC's Accounting Practices and Procedures Manual, SSAP #53, Paragraph 6 when calculating the Company's unearned premium reserve on "run-off" policies.

Unearned Premium Reserve (Page #33)

It is recommended that the Company set up estimated accruals for both Written Premium and Unearned Premium Reserve that represent written premium and UPR from the cutoff dates to year-end.

Commissions Payable (Page #34)

It is recommended that changes in contract terms be communicated timely to the accounting department so that the appropriate accounting entries can be made.

Escheatable Property (Page #34)

It is recommended that the Company comply with the various state laws regarding escheatable property.

Accounts Payable (Page #34)

It is recommended that the Company develop procedures to ensure that accruals are made for services performed in the current year that remain unpaid at year end.

Deductible Recoverables (Page #34 & 35)

It is recommended that the Company research and clear the negative deductible balances including issuing a refund to the claimant if it is found that the Company has received deductible payments in excess of the recoverable

It is recommended that the Company comply with SSAP 65 paragraph 37 and non-admit deductible recoverable balances over 90 days past their contractual due date or billing date if no contractual due date has been established.

Over 90 Day non-admit Receivables (Page #35)

It is recommended that the Company ensure that they post all non-admitted premium receivable balances in compliance with SSAP 6.

Non-admitted/Offset Calculation (Page #35)

It is recommended that the Company perform a calculation each year to determine if any accrued retrospective premiums should be non-admitted per the requirements of SSAP 66, paragraph 9.

Over Cession of Reserves (Page #35)

It is recommended that the Company ensure future cessions are allocated correctly and ensure that future financial statements are completed correctly in compliance with the NAIC Annual Statement Instructions.

IBNR Re-allocation (Page #36)

It is recommended that the Company comply with SSAP #62, paragraphs 17-20 by not taking credit in Schedule F for ceded recoverables due from insolvent reinsurers.

Developmental Deficiency on Loss Reserves (Page #36)

It is recommended that the Company use a more conservative approach when calculating their loss reserves.

Audited Financial Statements for MGAs (Page #51)

It is recommended that the Company obtain audited financial statements for all of its MGAs.

Actuarial Opinion of MGA Reserves (Page #51)

It is again recommended that the Company comply with its agreements and 18 Del. C. § 1805(b) by annually obtaining the opinion of an actuary attesting to the MGA's adequacy of its established loss reserves for losses incurred and outstanding on business produced by the MGA. This is in addition to any other required loss reserve certification.

CONCLUSION

The following schedule shows the results of this examination and the results of the prior examination with changes between the examination periods:

<u>Description</u>	<u>December 31, 2002</u>	<u>December 31, 2005</u>	<u>Increase</u>
Assets	\$413,871,172	\$528,252,497	\$114,381,325
Liabilities	\$378,597,226	\$399,349,889	\$20,752,663
Capital and Surplus	\$35,273,946	\$128,902,609	\$93,628,663

The assistance of Delaware's consulting actuarial firm, INS Consultants, Inc. is acknowledged.

Respectfully submitted,



Michael A. Davis, CFE
Examiner-In-Charge
State of Delaware
Northeastern Zone, NAIC